

Who Pays the Lion's Share of Personal Income Tax?

Sinclair Davidson

Perspectives on Tax Reform (4)

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Foreword

This is the fourth in a series of short Policy Monographs which aims to consider various aspects of tax reform. In this paper, Sinclair Davidson focuses on the treatment of higher rate income tax payers in Australia. He develops three basic arguments.

The first is that the tax burden has shifted in recent years away from low and middle income earners onto high income earners. This will surprise many readers, for political activists and pundits commonly assert that higher income earners have done better than anybody else as a result of tax changes during the Howard years. But Davidson shows the public has been misled. In 1996/97, the top 25% of income earners paid 61% of total net tax; by 2000/01 they were paying 64% of it.

His second point follows directly from this. It is clear that higher income earners are paying the lion's share of income tax. Davidson shows that three-quarters of the population is paying less than its proportionate share in tax while one-quarter is paying more. The idea that 'the rich' are getting away with paying very little while low and middle income earners are being left to shoulder the burden is shown to be entirely false, and Davidson lambasts the 'campaign of vilification and obfuscation' waged by socialist politicians like Wayne Swan and socialist academics and journalists like John Quiggin that has so muddied our understanding of what is actually going on.

It is hardly surprising that a minority of higher earners has ended up paying the bulk of the income tax, for in a majoritarian democracy, politicians will always be tempted to expropriate monied minorities while bestowing their beneficence on the majority of voters in the middle of the income scale. You don't risk many votes when you 'hit the rich', but you can buy a lot of popularity with the proceeds.

Some people think it is only 'fair' that people on higher incomes should lose a much bigger proportion of their earnings than those on lower incomes. Many socialists and egalitarians think it is entirely appropriate that the tax system should be used to flatten out final incomes (what Davidson calls the 'Total Confiscation' principle), and some suggest that more affluent people will not particularly miss the extra cash that is taken away from them. Arguments like these lead Davidson to his third key proposition, which is that there is no principled justification to support so-called 'progressive taxation'.

Today we have become accustomed to the idea that progressive taxes are fair and just, but Davidson shows that this was an issue that exercised the minds of some great economists and philosophers in the past and all of them concluded that such taxes are not fair or just. Adam Smith, John Stuart Mill and Friedrich Hayek all examined the arguments and came to the conclusion that a *proportionate tax* (where everybody pays the same proportion of their total income in tax) is fair, but that a *progressive tax* (where those on higher incomes pay an increasingly large proportion of their total earnings in tax) is not. Davidson himself goes back over the various arguments that have been advanced for progressive taxation and finds all are flawed or fallacious. He concludes that the main reason we have progressive taxation is because it allows politicians to raise the most revenue with the least resistance.

Davidson's paper helps strengthen some of the arguments developed in earlier papers in this series. Geoffrey de Q. Walker, for example, pinpointed the growing resentment that taxpayers feel at having to pay unreasonably high and capricious tax levies, and he recommended that the top rate should be cut to 30% and that tax thresholds should be raised and indexed to inflation. Davidson's argument reinforces this plea for a flat rate tax of 30%. Walker argued for a low flat rate mainly on the grounds of efficiency because it would make the tax system much simpler and would probably end up generating just as much money as the present system manages to achieve. Davidson arrives at the same conclusion via a different route, that a flat rate tax would be fair in a way that our present progressive tax system is not.

Davidson also reinforces some of the points developed in the paper I wrote with Barry Maley where we focused on the disincentives created by our high income taxes. We pointed out that Australia takes a higher proportion of GDP in tax than either Japan or the United States and that taxation of personal and corporate incomes is very high by international standards.

Davidson confirms this and helps counter fallacious claims that Australia is a low-tax country.

As we approach a Federal election in which tax is looming as one of the key issues, it is vital that debate should be properly informed. Davidson's paper performs a service by exposing the absurdities of some of the claims that are being made about who pays what. Higher income earners are paying much more than their 'fair share' in tax, and despite the changes to the top income tax brackets in the 2004/05 Budget, they are the group that has been hit hardest by the Howard government. The case for radical reform to reduce the top rate of income tax is compelling, for not only is it the 'economically rational' thing to do, but it is also the fair thing to do.

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Executive Summary

Tax policy is always important in an election year. Debates arise over whether Australia is a 'high-taxing' economy, who is paying the most personal income tax and whether or not the tax system is 'fair'.

It is often argued that Australia's taxation as a proportion of GDP is low by OECD standards, making Australia a 'low-tax' economy, but when personal income tax is calculated as a proportion of total tax revenue, Australia's taxation level is the fourth highest amongst OECD countries. While OECD comparisons are ambiguous, compared to ASEAN countries, Australia's direct tax is high by any measure. Not only this, but Australia's top marginal tax rate applies very quickly to income at 1.1 times per capita GDP, comparing unfavourably to the United States at 8.46 times per capita GDP, or 9.53 times per capita GDP in Singapore.

It is a common yet misguided belief that 'the rich' do not pay their fair share of tax and that anyone with a good accountant faces a 'voluntary' tax regime. Individual taxpayer data from the Australian Tax Office shows that in 2000/01 (latest available data), the top 25% of taxpayers paid 64.1% of the net tax after rebates, credits and Medicare. This has steadily increased since 1996-97 where high income earners paid 60.8% of net tax. All other taxpayers have experienced a decline in net tax payments. This is not an effect of GST reform because calculations adjusting the net tax for the impact of the GST (which still overstate its effect), continue to show that the top 25% of taxpayers shoulder the greatest burden of net tax payments and pay 62.4% of net tax.

But is this 'fair'? Some would argue that it is 'fair' that those on higher incomes should lose a much larger percentage of their income than low income earners, as is the case under a progressive tax system. The problem is that 'fairness' is then arbitrary and highly contestable. As long as an individual pays the amount specified the government and not a dollar less, they have paid their 'fair share'. On the other hand, a proportional tax system is inherently fair because an equal percentage of tax to total income is paid by all individuals, regardless of their income.

If 'fairness' is defined as proportional taxation, then in 2000/01, 85% of Australians paid less than their fair share in taxes and the top 5% of income earners in Australia paid 158% of their fair share in net taxes. The combination of the 'milkshake and sandwich' tax cuts in the 2003/4 Budget and the family payments and threshold reforms announced in the 2004/05 Budget means that by 2005/6, this figure will probably rise significantly. The tax reforms in the last two years will thus have the effect of increasing the relative tax burden on those Australians with the highest incomes and further reducing the tax burden for those with low and middle incomes.

Income tax policy is an emotive issue and facts and statistics are early casualties in the lead up to this year's elections. Some argue that Australians can and should pay more in tax but, unwisely, they rely on public debate and understanding about taxation which has not been informed by empirical evidence.

Acknowledgements

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Introduction

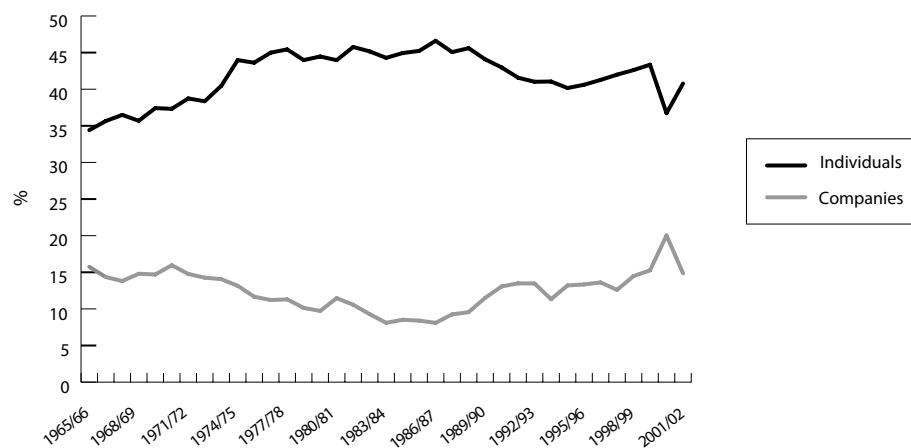
When governments have a budget surplus, the question of what to do with the money always arises. Should taxes be cut or government spending increased? If taxes are cut, whose taxes should be cut first, or the most? Most voters are taxpayers and have a vested interest in what happens to their money. This election year we are going to hear the arguments rehearsed in great detail.

One argument in particular has gained currency in Australia, the notion that income tax burden on ‘battlers’ and middle-Australia has risen under the Howard government. The implication is that these income groups are being ‘unfairly’ taxed while high income earners do not pay their ‘fair’ share of tax. When rhetoric is swept aside and taxation data is examined more carefully, evidence shows that, contrary to popular belief, it is relatively high income earners who are paying the lion’s share of personal income tax.

Is Personal Income Tax High in Australia?

The Australian Bureau of Statistics reports that income taxes levied on individuals constituted just over 40% of total taxation revenue for the 2001/02 financial year.¹ The comparative figure for income tax levied on enterprises was 14.65%. Individuals therefore contribute almost three times as much in the way of income tax than do enterprises (see Figure 1). In addition, revenues from company taxes are higher in Australia than in any other OECD economy.² Our reliance on direct taxation of incomes is very high when compared with other countries.

Figure 1: Share of Total Tax Revenue, 1995/96 to 2001/02



Source: OECD, see www.sourceoecd.org

Australia is often described as a ‘high-taxing’ economy. The Index of Economic Freedom, the Economic Freedom of the World and the Global Competitiveness reports all score Australia poorly on taxation. Indeed the Global Competitiveness report lists the Individual income tax rate as a Notable Competitive Disadvantage.

The ACTU disagrees. It argues that taxes can be increased because Australia’s taxation as a proportion of GDP is low by OECD standards, making Australia a ‘low-tax’ economy.³ However, when direct income tax is calculated as *a proportion of total tax revenue*, Australia’s taxation level is the fourth highest amongst the sample of OECD countries. Admittedly, this comparison excludes Social Security contributions which are ‘taxed separately’ from income tax in many OECD economies. If Social Security contributions are added to the income tax take, then Australia does fall lower down the rankings. However, the OECD data assume that Australia has no Social Security collections and, while literally true, for practical purposes this is not entirely correct. For example, the so-called Medicare Levy and compulsory Superannuation contributions are effectively Social Security taxes.⁴ To the extent that OECD economies include services such as this under the rubric of social security while Australia does not, OECD comparisons are misleading.⁵ When Australia is compared to the ASEAN economies such as Korea (South), Singapore and Taiwan, Australia’s reliance on direct tax is high by any measure.

To determine whether Australia is a 'high-taxing' economy, the ratio of top marginal tax rate threshold income to GDP per capita was calculated using data from the World Bank Development Indicators database (Table 1). To clarify, marginal tax rates and income levels are defined as the statutory rates.⁶

Unfortunately, coverage (especially for the income level above which the top marginal tax rate applies) is somewhat patchy with no data for any economy in 2001. It is important to note that Australia has one of the lowest ratios (8th of the 39 economies shown) and the top marginal tax rate applies very quickly to average national income. Not only this, but also four of the economies with lower ratios than Australia's are transitional economies. Overall the ratio has been declining for Australia and most economies indicating that GDP has been growing at a faster rate than tax threshold adjustments. This bracket creep will continue as long as the 'growth' in GDP is a function of inflation.

Table 1: Ratio of Marginal Tax Threshold Income to GDP Per Capita, 1998 to 2002

Country	1998	1999	2000	2002
Argentina	9.87	16.84	9.95	11.33
Australia	1.37	1.23	1.28	1.10
Austria	2.25	2.28	1.73	1.83
Belgium	2.83	2.88	2.17	1.49
Botswana	3.56	2.65	1.96	1.71
Brazil	2.90	2.56	1.49	1.41
Canada	1.71	1.49	1.46	2.19
Chile	0.79	0.77	0.61	0.68
China	3.78	3.48	3.15	2.69
Colombia	6.60	5.63	5.72	5.78
Czech Republic	1.90	2.86	0.62	0.60
Ecuador	19.99	—	3.51	14.39
Germany	2.87	2.75	2.12	1.89
Greece	3.91	3.70	2.84	1.16
Hungary	0.51	0.40	0.29	0.33
India	2.41	1.57	1.35	1.22
Indonesia	3.27	2.33	6.90	6.13
Ireland	0.64	0.57	0.79	0.77
Italy	8.11	3.53	2.60	2.47
Japan	9.75	10.66	6.10	5.32
Korea, Rep.	4.68	4.90	4.21	3.66
Luxembourg	1.68	1.63	1.16	0.55
Malaysia	5.26	4.95	4.44	7.37
Mexico	3.26	24.59	29.23	29.66
Netherlands	2.09	2.21	1.60	1.58
New Zealand	1.15	0.97	1.42	1.21
Pakistan	—	—	9.12	5.52
Peru	11.32	10.64	9.72	9.47
Philippines	3.51	3.49	2.60	2.42
Poland	1.68	1.67	1.82	1.83
Portugal	2.27	2.30	2.74	2.60
Romania	0.68	0.75	0.42	0.59
Singapore	12.50	11.63	16.94	9.53
Slovak Republic	3.08	2.74	2.13	0.94
South Africa	2.33	2.25	1.57	1.83
Spain	3.96	4.17	3.42	2.95
Thailand	15.01	18.24	14.70	13.62
United Kingdom	2.03	2.02	1.79	1.69
United States	9.10	8.84	8.76	8.46

Denominator is Threshold Income for Marginal tax rate in US dollars and numerator is GDP per capita (PPP approach in current US\$).

Source: Using data from World Bank Development Indicators Online, see www.worldbank.org

So far, two facts are clear. First, Australian individuals pay the bulk of taxes in the form of direct income tax and, second, the top marginal tax rate applies very quickly relative to national income. It is therefore not surprising that tax has been an important electoral issue over the past few years. According to the Australian Election Study,⁷ at the 2001 election, 85.5% of voters believed tax policy was very important, with 16.3% stating it to be the most important issue at the election. Overall, taxation was the second most important issue after education (17%) and before health (16.1%). This statistic does not relate to Labor's vague promise to 'roll-back' the GST because the Australian Election Study investigated the GST separately, rating it the fifth most important issue (12.8%). Taxation has long been important to voters, rating as the second most important issue at both the 1998 (23.3%) election and the 1996 (18.3%) election.

Who Pays Personal Income Tax in Australia?

Wayne Swan, the Labor Party spokesman on Family and Community Services, recently argued, 'Australians on low and middle incomes are shouldering more of the tax burden than those at the top . . .'.⁸ Others share Swan's view. For example, Stephen Harrison, the chief executive of The Institute of Chartered Accountants of Australia, has stated, 'Australia has one of the highest levels of reliance on personal income taxes in the OECD with a disproportionate tax burden falling on the middle-income earner'.⁹ These views are commonly held, but are not supported by any evidence.

To evaluate the 'Swan proposition', I investigated the Australian Tax Office *Taxation Statistics*,¹⁰ analysing the subset of data on individual income tax. Individual tax returns have been broken down into quantiles ranked from lowest to highest income. The data are not precisely comparable across years because the number of individuals in each quantile varies by year due to data collection dates varying and the number of returns at that date. However, the source of variation is small and is unlikely to bias the results of the analysis.

Table 2 shows the percentage share of net tax¹¹ for each quantile relative to total net tax paid by individuals. This share is reported for each year from 1996/97 to 2000/01 and covers the period from Peter Costello's first budget to the latest available data. It is plain to see that the tax share increases monotonically and dramatically as income increases and there is a trend, albeit slight, for tax shares to fall across time except for the highest quantile.

Swan does not state what 'low', 'middle' or 'top' incomes are in his view, so I have had to define these categories myself. Based on the average income for 2001, the bottom five quantiles are classified as low income earners (with an average income of \$14,225), the middle ten quantiles are middle income earners (average income of \$32,842) and the top five quantiles are high income earners (average income of \$79,052). The final three rows contain the tax

shares of these three groups. It is clear that the tax burden has increased for high income earners and fallen for middle and low income earners. Additionally, the ATO 'net tax' does not appear to include the Superannuation Surcharge Tax, so to that extent the tax contribution of 'high' income earners who are liable for that surcharge is still underestimated.¹²

The data in Table 2 also provides some insight into the 2004/05 Budget decision to limit tax relief to individuals earning more than \$52,000 (those earning less than this were compensated with a generous increase in means-tested family payments rather than tax cuts). Challenged to justify this on the ABC's *7.30 Report*, the Treasurer, Peter Costello, said it was difficult to provide large tax cuts to those earning less than \$52,000 since they pay comparatively little in tax in the first place.¹³ This comment is consistent with the patterns of taxation shown in Table 2. Any tax cuts will necessarily impact on high income earners more than on low income earners because in a progressive income tax system, higher earners pay most. Any tax cuts will be returned to taxpayers in the same proportion as they contribute to tax revenue. In a progressive tax system, in other words, just as low and middle income earners pay progressively less in tax, so too they receive progressively less in tax cuts.

Australian individuals pay the bulk of taxes in the form of direct income tax and the top marginal tax rate applies very quickly relative to national income.

Table 2: Net Tax Per Quantile as a Percentage of Total Net Tax, 1996/97 to 2000/01

Quantile	1996/97	1997/98	1998/99	1999/00	2000/01
5	0.2	0.2	0.2	0.2	0.2
10	0.4	0.4	0.4	0.4	0.4
15	0.6	0.6	0.6	0.6	0.6
20	0.9	0.9	0.9	0.9	0.9
25	1.3	1.2	1.2	1.2	1.1
30	1.6	1.5	1.5	1.4	1.4
35	1.9	1.8	1.8	1.8	1.8
40	2.3	2.3	2.3	2.3	2.2
45	2.8	2.8	2.8	2.7	2.6
50	3.3	3.2	3.2	3.1	3.0
55	3.7	3.7	3.7	3.6	3.4
60	4.2	4.2	4.1	4.1	3.8
65	4.8	4.7	4.7	4.5	4.3
70	5.4	5.3	5.2	5.1	4.8
75	6.0	5.9	5.9	5.8	5.4
80	6.9	6.8	6.8	6.7	6.1
85	8.0	7.9	7.9	7.8	7.0
90	9.4	9.4	9.4	9.3	8.4
95	12.0	12.1	12.1	11.9	11.3
100	24.5	25.0	25.4	26.8	31.3
Bottom 25%	3.4	3.4	3.4	3.2	3.1
Middle 50%	36.0	35.4	35.1	34.3	32.8
Top 25%	60.8	61.2	61.5	62.4	64.1

Source: Using data from the ATO, *Taxation Statistics*, see www.ato.gov.au

The analysis in Table 2 does not include the Goods and Services Tax (GST) introduced in the 2000/01 financial year. According to the ABS, the GST raised \$23.85 billion in 2000/01.¹⁴ It is possible to re-evaluate the personal tax data taking account of the GST, but this would provide only a rough and ready analysis because the GST was introduced as a trade-off on personal income tax, wholesale sales tax and several state taxes. Strictly speaking, the net GST should be added back to the analysis. The fall off in wholesale sales tax in 2000/01 was \$13.668 billion (the difference between \$15.64 billion in 1999/00 and \$1.9 billion in 2000/01). So, abstracting from the state taxes, inflation, economic growth and the like, I estimate the net GST to be \$10.186 billion (the \$23.85 billion less the \$13.668 billion in foregone wholesale sales tax). As the GST is a consumption tax, the GST funds can be allocated across the quantiles by income share. Adam Smith tells us that indirect taxes 'will in most cases be nearly in proportion to their revenue'.¹⁵ Not all readers will accept my arguments here, so, using 2000/01 data from Table 2, the net GST distributed by total income share and proportionally and the gross GST distributed by total income share and proportionally has been added. Relative tax share per quantile has been calculated with the results shown in Table 3.

Fundamentally the story remains the same. The bulk of personal taxes is being paid by the top 25% of taxpayers.

While the precise details differ, fundamentally the story remains the same. The bulk of personal taxes is being paid by the top 25% of taxpayers. It is tempting to compare Tables 2 and 3 and conclude that low income earners were less well off under the GST, but data across the two tables are not comparable because indirect taxes have not been added to Table 2.

Table 3: GST-adjusted Net Tax Per Quantile as a Percentage Of Total Net Tax

Quantile	Net GST		Gross GST	
	Income Share	Equal Share	Income Share	Equal Share
5	0.3	0.7	0.4	1.3
10	0.5	0.9	0.6	1.4
15	0.8	1.1	0.9	1.6
20	1.0	1.4	1.2	1.9
25	1.3	1.6	1.4	2.0
30	1.5	1.8	1.7	2.2
35	1.9	2.2	2.1	2.5
40	2.3	2.5	2.5	2.9
45	2.7	2.9	2.8	3.2
50	3.1	3.2	3.2	3.5
55	3.5	3.6	3.6	3.8
60	3.9	4.0	4.0	4.1
65	4.4	4.4	4.4	4.5
70	4.9	4.8	4.9	4.9
75	5.4	5.4	5.5	5.3
80	6.1	6.0	6.1	5.8
85	6.9	6.7	6.9	6.5
90	8.3	8.0	8.3	7.6
95	11.1	10.6	10.8	9.8
100	29.9	28.2	28.6	25.1
Bottom 25%	3.8	5.7	4.5	8.3
Middle 50%	33.8	34.8	34.8	36.8
Top 25%	62.4	59.6	60.7	54.9

Notes: Net GST is GST less the change in Wholesale Sales Tax. GST revenues have been allocated to quantiles as a proportion of Total Income and on an equal basis.

Source: Using data from the ATO, *Taxation Statistics*, see www.ato.gov.au and ABS, *Taxation Revenue Cat. 5506.0*.

Is Progressive Taxation 'Fair'?

An argument often heard is that 'the rich' do not pay their fair share of tax. This is a value judgement, pure and simple. Those who argue this often imply (and sometimes explicitly claim) that 'the rich' have not earned their wealth, that it is inherited, illegitimate or acquired through good fortune. Wayne Swan, for example, writes that progressive taxation—where those on higher incomes pay an increasingly large proportion of their earnings in tax—delivers 'fairness rather than reward for inherited wealth'.¹⁶

Another argument often heard is that income inequality is somehow undesirable and the tax system should operate to equalise after-tax income.¹⁷ This is the 'Total Confiscation' principle.¹⁸ While the ACTU lists this as their first principal objective of a fair tax system, few economists (or voters) would subscribe to such a policy.

An argument often heard is that 'the rich' do not pay their fair share of tax. This is a value judgement, pure and simple.

A more subtle version of this idea is the 'ability to pay' principle. This is a price discrimination argument which states that 'the rich' can afford to pay more in tax than 'the poor'. Though this may well be true, it does not justify progressive taxation. After all, the 'rich' are not required to pay more for their groceries than 'the poor' although they can easily afford to pay more. It follows that those who claim to support price discrimination in taxation would also have to support price discrimination by the private sector, which is highly unlikely. Ludwig Von Mises has argued that taken to its logical conclusion the ability to pay principle collapses into the 'Total Confiscation' argument.¹⁹

The most popular and perhaps sophisticated argument for progressive tax is the 'Equality

of Sacrifice' principle. Hayek believed that this argument carried the day in favour of the progressive tax rates that were introduced at the turn of the 20th century.²⁰ The idea is based on diminishing marginal utility where the more an individual has of a particular commodity, the less they value that commodity. Consequently, 'the rich' value their last dollar less than 'the poor' value their last dollar. On these grounds, 'the rich' can be taxed more than 'the poor' to equalise the tax burden.

This may sound plausible, but economists have savaged this line of reasoning. Hayek has written that an improved understanding of utility theory itself has, 'completely destroyed the foundations of this argument'.²¹ Paul Samuelson, who cannot be categorised as an anti-tax conservative, writes '[t]oday such arguments are not very fashionable ...'²² and shows that progressive income tax is not necessarily consistent with diminishing marginal utility.

The 'Equality of Sacrifice' theory itself relies on some strong and easily violated assumptions. For example, the theory assumes that individuals can be divided into income groups which are homogenous within themselves, who derive the same satisfaction from income and consume the same bundle of goods and services. It assumes that this satisfaction is measurable, comparable and known to the tax authority. John Stuart Mill suggests that decision makers will never have this type of information 'with the degree of certainty on which a legislator or a financier ought to act'.²³ Taken to its logical conclusion, the application of diminishing marginal utility to income leads to the stereotyping of particular income groups and is inconsistent with observable economic traits such as wealth accumulation. It is difficult to believe that individuals make great sacrifices to increase their wealth when they do not value the marginal increase in that wealth very highly. Hayek is correct to refer to the whole idea as being a 'regrettable mistake'.²⁴

While tax authorities may have argued that progressive taxation allows for equality of sacrifice and so on, it is more likely that they knew more revenue could be raised with a progressive tax.

There are other *ad hoc* arguments for progressive taxation, such as the notion that progressive income tax compensates for regressive indirect taxation. Others argue that equality is realised when taxation and government expenditure are evaluated concurrently. John Quiggin, for example, has written that, 'while taxation payments are roughly proportional to income, the benefits of public expenditure are about the same for all members of the community'.²⁵ He says that while low-income earners receive higher welfare benefits, 'middle and upper income earners receive a greater economic benefit from services such as police and national defence, since they have more to lose'.²⁶ This is an appalling slur on the morality and patriotism of low income earners.

Some 150 years ago, John Stuart Mill wrote in answer to this sort of argument that, 'we should have to consider who would suffer most if [government] protection were withdrawn . . . it must be, that those would suffer most who were weakest in mind or body, either by nature or by position'.²⁷ Quiggin, in his rush to justify progressive taxation, reverses the notions of 'distributive justice' and civilised society. Government and civilised society exist to protect the weak. Ultimately, the Quiggin argument undermines the dignity of low-income earners and equality before the law.

Despite the weakness of the arguments used to justify it, progressive taxation is still the norm in most economies.²⁸ Hayek provides a description of how progressive taxation was introduced, arguing that progressive taxation was smuggled in under false pretences when the 'Equality of Sacrifice' argument was still novel. Those who argued that progressive taxation was 'the thin end of the wedge' were dismissed as outrageous scare mongers.²⁹ As in many other areas, principle has followed practice and while tax authorities may have argued that progressive taxation allows for equality of sacrifice and so on, it is more likely that they knew more revenue could be raised with a progressive tax.³⁰

Proportional Taxation is Fair

Under a progressive tax system, 'fairness' is arbitrarily defined according to whatever the current tax rates are.³¹ As long as an individual pays the amount specified by the parliament and not a dollar less, they have paid their 'fair share', but under this definition, any share of tax paid could

be considered 'fair'. In the end, any sense of fairness in a progressive system of taxation can only be arbitrary and will therefore always be contested.

This is very different in a proportional tax system. In Hayek's discussion of taxation, he argues that proportional taxation is intuitively fair, while progressive taxation is arbitrary and unjust.³² Adam Smith similarly supported proportional taxation because it rests on a commonly understood criterion of fairness as equal treatment. John Stuart Mill wrote, 'I can see no fairer standard of real equality than to take from all persons, whatever may be their amount of fortune, the same arithmetical proportion of their superfluities.'³³ There is, therefore, an intuitive sense of 'fairness' in the idea of proportionality which is completely absent in progressive taxation systems.

Following Smith, Mill, and Hayek I define 'fair' taxation as proportional taxation. Based on this definition, we have already seen in Table 2 that many individuals in Australia are *not* paying their fair share. This can be made clearer in Table 4 which contains the percentage ratio of tax share to income share for the ATO quantiles. If the individuals in any quantile were paying their fair share, as defined, the figure in Table 4 would be 100. If individuals are paying less than their fair share the figure will be less than 100 and if they are paying more than their fair share the figure will be more than 100.

There are a number of features in Table 4 worth discussing. First, note that the overwhelming majority of taxpayers pay less than their share of income as tax. Before the 2000/01 tax year, 75% of all taxpayers had a greater income share than tax share and in 2000/01 this increased to 85%. For taxpayers between the 75th and 85th quantiles the tax burden fell so that they too paid less than their fair share in tax. For taxpayers between the 85th and 95th quantiles the tax burden fell, but they still paid more than their fair share of income in taxes. The tax burden for those taxpayers in the top quantile increased. There are, however, some anomalies in the data. Taxpayers in the 15th, 20th and 35th quantiles, while still paying far less than their fair share, did experience an increase in net tax share as a percentage of total income. Overall, however, the data in Table 4 indicate that the overwhelming majority of taxpayers pay less than their fair share of tax and that this majority increased in 2000/01.

Table 4: Net Tax Share as a Percentage of Total Income Share, 1996/97 to 2000/01

Quantile	1996/97	1997/98	1998/99	1999/00	2000/01
5	16.67	16.96	17.27	17.65	14.42
10	25.00	26.92	27.74	27.21	23.97
15	31.58	33.16	33.51	33.15	34.25
20	40.91	41.63	42.15	41.31	41.67
25	52.00	48.62	47.43	47.13	44.98
30	55.17	53.52	52.11	51.64	49.64
35	59.38	58.47	58.33	58.22	58.82
40	65.71	66.37	67.45	67.66	66.47
45	73.68	74.46	74.86	74.66	72.10
50	80.49	80.35	80.25	79.70	76.92
55	84.09	85.25	85.15	84.47	81.19
60	89.36	89.72	89.03	88.43	84.77
65	94.12	93.65	92.81	91.90	88.11
70	98.18	97.24	95.92	95.11	91.46
75	101.69	100.68	101.03	100.87	94.24
80	107.81	107.22	107.24	106.68	97.28
85	114.29	113.45	113.04	112.30	102.20
90	120.51	119.85	120.51	119.74	110.18
95	129.03	129.71	129.85	128.66	123.04
100	141.62	140.99	140.65	138.24	158.06

Source: Using data from ATO, see www.ato.gov.au

Tax Reform

The Howard government introduced tax reforms in the late 1990s which culminated in the introduction of the GST in 2000. These tax reforms aimed to reduce the tax burden on high income earners, yet Tables 2, 3 and 4 indicate that the tax burden actually rose for high income earners and fell for most taxpayers.

Table 5 contains the results of a 'mental experiment' in which we ask: what if the tax system had remained unchanged? Using quantile tax share data for each year 1996/97 through 1999/00, Table 5 shows net tax had the tax reform not occurred.

Overall the data indicate that the tax burden has fallen for the majority of Australians, save for those in the 100th quantile whose tax burden rose quite dramatically. There are also some marginal increases for taxpayers in the 15th, 20th and 35th quantiles, however, over the entire period it is difficult to argue that these taxpayers are worse off in 2000/01. While some caution needs to be taken when relying on this type of analysis (which depends on extremely strong *ceteris paribus* assumptions), the overall message remains the same: the tax burden falls on higher income earners and not on low and middle income Australia.

Table 5: Estimated Net Tax Shares as if Tax Reform Never Occurred

Quantile	Estimated 1996/97	Estimated 1997/98	Estimated 1998/99	Estimated 1999/00	Actual 2000/01
5	0.20	0.19	0.19	0.18	0.15
10	0.40	0.42	0.43	0.40	0.35
15	0.60	0.63	0.64	0.60	0.62
20	0.90	0.92	0.94	0.88	0.90
25	1.30	1.23	1.20	1.15	1.12
30	1.60	1.52	1.48	1.42	1.37
35	1.90	1.83	1.82	1.77	1.80
40	2.30	2.27	2.30	2.26	2.22
45	2.79	2.77	2.77	2.71	2.61
50	3.29	3.23	3.21	3.14	3.00
55	3.69	3.70	3.67	3.59	3.41
60	4.19	4.19	4.14	4.05	3.84
65	4.79	4.72	4.65	4.54	4.30
70	5.39	5.28	5.17	5.06	4.82
75	5.99	5.90	5.88	5.80	5.40
80	6.89	6.83	6.81	6.71	6.09
85	7.98	7.93	7.89	7.76	6.96
90	9.38	9.36	9.40	9.28	8.44
95	11.98	12.05	12.05	11.94	11.32
100	24.45	25.04	25.36	26.75	31.28

Source: Using data from ATO, *Taxation Statistics*, see www.ato.gov.au

In the 2003/04 and 2004/05 tax years additional reforms to the tax system were undertaken. Unfortunately, the ATO data is out-of-date and we can only speculate on the impact of these changes. It seems likely, however, that the 'milkshake and sandwich' tax cut in 2003 will have accentuated the unfairness of the existing taxation arrangements—even fewer taxpayers would have been paying their 'fair share' after this budget.

As for the 2004/05 Budget reforms, two effects are at work. First, families with children and a household income less than \$52,000 receive an increased family payment. Families that qualify for family payments will end up paying less in net tax. This will have the effect of reducing the net tax of low and middle income earners, however this effect will not be uniform across the quantiles as family payments are only directed towards taxpayers with children.

Second, individual taxpayers with income above \$52,000 receive a tax break.³⁴ The raising of the top two tax brackets was widely presented as a ‘regressive’ policy for it reduced the amount of tax paid by higher rate taxpayers. But extending the 30% and 42% income brackets to higher levels of income will paradoxically have the effect of further reducing the proportion of Australians who pay a fair share of their income as tax.

In Table 4 we saw that 85% of Australians paid less than their fair share in taxes in 2000/01. The combination of the ‘milkshake and sandwich’ tax cuts of 2003/04 and the family payments and threshold reforms announced in the 2004/05 Budget means that by 2005/06, this figure will probably have risen to at least 90%. The tax reforms in the last two years will thus have the effect of increasing the relative tax burden on those Australians with the highest incomes and further reducing the tax burden for Australians with low and middle incomes.

Conclusion

Many people believe that ‘the rich’ do not pay their fair share and that they face a voluntary tax regime whereas everyone else pays an ever increasing share of tax. Data presented in this paper proves this is not the case—low and middle income earners are not shouldering more of the tax burden.

Geoffrey de Q. Walker argues that the ‘revenue lobby’ (comprising the ATO, the Treasury and their allies in politics, academia, the media and the welfare industry) have hijacked public debate³⁵ by creating false impressions and perpetuating a campaign of vilification and

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obfuscation. Consider Wayne Swan’s opinion piece in *The Australian* which argues that Australian families are paying punitive rates of tax (defined as effective marginal tax rates) and some³⁶ want ‘chief executives on multi-million dollar base salaries’ to pay less tax. There are three confusing aspects to this comment. First, Australian families do not submit joint tax returns. Second, by concentrating on effective marginal tax rates Swan and the revenue lobby confuse the tax system with the welfare system. Third, and most important, Swan gives the impression that individuals with multi-million dollar base salaries are

common. In the 1998/9 financial year,³⁷ the ATO reported only 431 individuals who earned more than \$1 million. By its vagueness in defining who in particular the ‘rich’ are³⁸ and using extremely high income individuals as examples, the revenue lobby sows confusion. If, according to John Quiggin, tax is voluntary for anyone who can afford a good accountant,³⁹ then Table 2 indicates that the top 25% of income earners in Australia ‘voluntarily’ pay 64.1% of the net tax.

Income tax is an emotive issue. Statistics and facts have been early casualties in the lead up to this year’s elections. The income tax burden is not falling on middle income earners and the poor. Evidence clearly shows that the tax burden has increased for the top end of the income distribution.

Some still continue to argue that Australians can, and should, pay more in tax. Australia is a democracy and everyone is entitled to their own opinion. They are not, however, entitled to their own facts.

Endnotes

- ¹ ABS, *Taxation Revenue*, Cat. 5506.0 (Canberra: ABS, 2002) As a proportion of Commonwealth tax, the income tax raised 49.23% of revenue. I have collected data relative to the total tax take (Federal, State and Local) in order to circumvent arguments that individuals, in some economies, may pay income tax at federal and state levels and that social security is treated separately. See T. Dixon and J. O'Mahony, 'Taxation Statistics Contain Pitfalls for the Unwary', 'Lies and Statistics', *The Australian Financial Review* (7 February, 2004), 63.
- ² OECD, see www.sourceoecd.org
- ³ ACTU, *A Fair-Australia Tax Policy (2003)*, see www.actu.asn.au/congress2003/draftpolicies/taxpolicy (Accessed March 18, 2004)
- ⁴ I would argue further that the Superannuation Surcharge and the semi-compulsory private health care insurance, or alternatively the Medicare surcharge, should also be counted as Social Security contributions.
- ⁵ For more discussion on international tax comparisons with OECD countries, see Peter Saunders and Barry Maley, *Tax Reform to Make Work Pay*, Policy Monograph 62 (Sydney: The Centre for Independent Studies, 2004), 2-3.
- ⁶ The 'effective marginal tax rate' which arises out of the interaction between the tax system and a means tested social welfare system has not been included. While it cannot be denied that perverse incentives can, and do, arise from that interaction this is a moral hazard issue associated with welfare systems and not tax systems. Tax is an involuntary payment from citizen to the state. Welfare is a voluntary payment from the state to citizen. While the term 'effective marginal tax rate' is in common use it creates confusion.
- ⁷ C. Bean, D. Gow and I. McAllister, *Australian Election Study*, 2001 [computer file], (Canberra: Social Science Data Archives, The Australian National University, 2002). Those who carried out the original analysis and collection of the Australian Election Study data bear no responsibility for my analysis or interpretation of the data.
- ⁸ *The Australian* (9 January, 2004).
- ⁹ D. Uren, 'Income Tax Overhaul Urged', *The Australian* (18 March, 2004).
- ¹⁰ See www.ato.gov.au listed under 'Booklets & Publications'. This data is available free online for the years 1996/97 to 2000/01. Data prior to 1996/97 is available, but cannot be downloaded.
- ¹¹ The ATO define 'net tax' as **gross tax** less rebates and any other credits plus the Medicare levy and Medicare surcharge. These credits may vary from year to year.
- ¹² According to some 'back of the envelope' estimates for the 2000/01 Superannuation Surcharge Tax the top 25% of income earners would have paid about 64.6% to 65.5% of taxes, a small but potentially significant increase on current estimates.
- ¹³ See the transcript at www.treasurer.gov.au/tsr/content/transcripts/2004/042.asp
- ¹⁴ ABS, *Taxation Revenue*, Cat. 5506.0
- ¹⁵ A. Smith (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*. (Chicago: University of Chicago Press, 1976), p. 399.
- ¹⁶ *The Australian* (January 9, 2004). Similarly, in a 2003 address to the Fabian Society, then Shadow Treasurer Bob McMullen listed 'Progressivism and Equity' as his first (of six) principle of taxation. See www.bobmcmullen.com/Releases%20&%20speeches/Speeches/20030531%20-%20Fabian%20Society%20in%20Melbourne%20.htm.
- ¹⁷ Henry Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), 19, for example, thought income inequality was 'distinctly evil'.
- ¹⁸ L. Mises, *Human Action: A Treatise on Economics*, Fourth Revised Edition (San Francisco: Fox & Wilkes, 1949).
- ¹⁹ As above.
- ²⁰ F. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).
- ²¹ As above.
- ²² P. Samuelson, (1947), *Foundations of Economic Analysis. Enlarged Edition* (Cambridge: Harvard University Press, 1983).
- ²³ J. S. Mill, (1848). *Principles of Political Economy* (New York: Augustus M. Kelley, 1989) p. 807.
- ²⁴ Hayek, *The Constitution of Liberty*.
- ²⁵ J. Quiggin, *Taxing Times: A Guide to Australia's Tax Debate* (Sydney: UNSW Press, 1998).
- ²⁶ As above, p. 21.
- ²⁷ J. S. Mill, *Principles of Political Economy*.
- ²⁸ It is true that Adam Smith can be quoted in support of progressive taxes, 'It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but

- something more than in that proportion' (1976, part 2, pg. 368). This, however, is in the specific context of house rental taxation. Smith, apparently, did not approve of conspicuous consumption.
- ²⁹ Charles Adams in *For Good and Evil: The Impact of Taxes on The Course Of Civilization* (London: Madison Books, 1993) also contains an excellent discussion on the introduction of progressive taxes.
- ³⁰ Hayek points out that the basis of public finance has been 'to raise the largest sums with the least resistance.' See F. Hayek, *Law, Legislation and Liberty Volume 3 The Political Order of a Free People* (Chicago: University of Chicago Press, 1979), 52. See also Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988).
- ³¹ John Kerry, the Democratic US-Presidential candidate has indicated that under his administration the 'rich' would be required to pay the same fair share as they did under President Clinton. Mr Kerry has not defined the how or why of 'fair', perhaps 'fair' is a noun in his lexicon.
- ³² Hayek, *The Constitution of Liberty*.
- ³³ J. S. Mill, *Principles of Political Economy*, 807.
- ³⁴ It is important to note the difference. The welfare system defines its operating unit as a household or family. The tax system defines its operating unit as an individual. This fundamental difference must be a source of some confusion and inefficiencies.
- ³⁵ G. Walker, *The Tax Wilderness: How to Restore the Rule of Law*, Policy Monograph 60 (Sydney: The Centre for Independent Studies, 2004).
- ³⁶ Swan was responding to an earlier opinion piece by Lauchlan Chipman. Chipman is implicitly vilified when Swan writes, 'We should not allow *people such as* Chipman to hijack this debate...' (emphasis added). Professor Chipman is hardly a disreputable member of society.
- ³⁷ The last year for which this particular data are available.
- ³⁸ Following media comments it seems that some in the Revenue Lobby consider individuals with more than \$52,000 as 'rich.' For example, *The Daily Telegraph* has 'Tax Cuts for All, Not Just the Rich' as its 14 May headline. In contrast, Mark Latham defines 'middle Australia' as having an income from \$30,000 to \$85,000 (*The Weekend Australian* May 14-15 2004), 1.
- ³⁹ Quiggin, *Taxing Times: A Guide to Australia's Tax Debate*.

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